No. 16010

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

GENE O. CLARK and FAYE CLARK,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Review of the Decision of the Tax Court of the United States.

REPLY BRIEF FOR PETITIONERS.

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Statement.

In our Opening Brief for the Petitioners, we believe we presented a concise and fairly articulate presentation of the case now on appeal. In contrast, the Respondent chose to ramble roughshod over the matters in dispute, ignoring in many instances some of the major contentions of the Petitioners. Because of Respondent's approach to this case, it now becomes necessary to pinpoint the untenable position which he has taken.

ARGUMENT.

A. The Tax Court Did Err in Its Determination of the Deficiencies.

The correctness of the Tax Court's conclusions is not supported by the record. The theory of the Commissioner which was adopted by the lower Court is clearly enunciated in Respondent's Brief (p. 46) wherein it is stated in all seriousness.

> "* * * it is pertinent to point out that it is the establishment of the availability of the constructive dividends to the taxpayer's use which is controlling with respect to taxability as income rather than the traceability of the diverted corporate funds into the taxpayers' respective pockets."

This contention points up the major error committed, not only by the Respondent but also by the lower Court. Merely because a corporation had earnings and profits available for distribution does not mean that such earnings were actually distributed. If the Respondent's proposition is correct, then every stockholder of a corporation could be taxable individually at any time the corporation has earnings and profits.

In the instant case, actual distributions were never shown to have taken place. Gene Clark testified that the fruits of his transactions ended up in the corporation [R. 330, 332, 393]. Also see testimony of Frederick Files [R. 266-268]. If the corporation did not report these profits, it does not mean the profits are attributable to the Petitioners.

If the Respondent believes that earnings and profits of a corporation are taxable to its stockholders whether they are distributed or not, it is no wonder that he says, "In

such a case, the effect of the receipt on the net worth of the stockholder is patently irrelevant" (Resp. Br. p. 37).

The Petitioners agree that distributed earnings may be in the form of machinery, equipment, trucks, buildings and land, or other property, and that if such property is distributed to the stockholders of a corporation, they would be considered dividends to the extent of the earnings and profits in the corporation. But the fact is, that there was not a distribution of such properties. They remained in the corporation and are reflected in its balance sheets during the period here involved [see Exs. A, B and C in the Appendix to Pet. Op. Br.].

The agent recognized this when he designated certain items as not being available for distribution in his Revenue Agent's Report, which was the basis of the deficiency notice. Respondent blandly asserts this so-called "reasonably effective method for determining income (Resp. Br. p. 36) can also be used to tax earnings and profits of the corporation to the Petitioners, which the deficiency notice manifested were not distributed to them, by the mere use of arithmetic after the trial is over (Resp. Br. pp. 43, 45).

It should be obvious that if the Respondent takes a new position that further earnings of the corporation were distributed to Petitioners, the burden is upon him to prove it by evidence, and not by calculations based upon an arbitrary theory.

The Respondent has made no attempt to defend Petitioners' attack upon the Tax Court's changing of the agent's allocation of distributions except to reiterate the opinion of the lower Court and state that he agrees with it. Respondent first says the controlling factor here is the establishment of available earnings and profits (Resp. Br.

p. 46) and that the traceability of such earnings to the taxpayers is not important. He maintains that based upon this theory, we must accept as a fact that there were *actual* distributions and concludes he may now abandon his own theory of allocation of these undistributed earnings to the calendar years of the Petitioners because *actual* distributions must first be applied against available earnings and profits (Resp. Br. pp. 52, 53).

The documentary evidence introduced by Respondent himself does not even support his position or that of the Tax Court [R. 124] that

> "On any appropriate basis of allocation of distributions ($85,827.47) from fiscal 1948 to calendar 1947 (which included eight months of fiscal 1948), the distributions attributable to calendar 1947 would be at least sufficient to encompass total ordinary dividends including the $31,520.24 attributable to Clark."

The only evidence in the record tending to show there were transactions of Gene Clark, Inc., which were not reported on its returns are the following checks:

Exhibit	Date	Amount
S	April 21, 1948	$ 1,558.44
Y	February 12, 1948	1,700.00
AA	September 20, 1947	2,731.54
CC	January 9, 1948	2,294.50
LL	January 29, 1948	3,074.74
MM	February 9, 1948	22,935.00
BBB	March, 1948	12,000.00
TT	February 10, 1948	2,223.76
UU	January 24, 1948	1,902.73
TOTAL		$50,420.71

It should be noted that Exhibit AA bears the endorsement of Archie Koyl, indicating he was the recipient of this check.

Exhibits U, V, W, X and DD, totaling $13,580.00, were also introduced into evidence but all of these checks were deposited in Gene Clark, Inc.'s bank account and reported by the corporation on its return.

The total of the aforementioned exhibits equals $64,-000.71 of alleged unreported income. Aside from this, the record is devoid of any evidence as to the remainder of the amount which Respondent asserted to be earnings and profits available and distributed to the stockholders of Gene Clark, Inc.

Even assuming the entire $64,000.71 was unreported income of the corporation, it does not automatically follow that Petitioners were the recipients of any of it, because, as has been repeatedly stated, there was no evidence to contradict Gene Clark's testimony that all of the profits of his transactions ended up in the corporation.

It must be observed that the vast majority of the exhibits introduced reveal transactions occurring in the calendar year 1948 and not in 1946 or 1947. How can a transaction which occurred in the calendar year 1948 be taxed to Petitioners in 1947?

The Respondent's own evidence does not support a finding that $45,028.91 was distributed to the stockholders of Gene Clark, Inc., in their calendar year 1947, or that $31,520.24 of such amount should be attributable to Petitioners.

The Respondent now recognizes that accrued taxes and penalties should be deducted from the net income of Gene Clark, Inc., to arrive at earnings and profits available for

distribution, but is silent as to the accrual of interest (Resp. Br. p. 51). It is presumed, therefore, he agrees that the Tax Court erred in not accruing the interest on such tax and assessed penalty.

Although the accrual of such items is conceded, they were not in fact taken into consideration when the lower Court determined the amount of distributions to the petitioners in their calendar year 1947 [R. 123].

Using the Tax Court's figures [R. 122], the total net income of Gene Clark, Inc., for fiscal 1948 was $104,-408.02. From this amount, $39,399.42 of accrued taxes and $19,979.69 of accrued penalties were deducted, leaving $45,028.91 of earnings available for distribution. If we now deduct accrued interest on such taxes and penalties in the amount of $2,963.99, we have a balance of $42,064.92 available for distribution. At this point, the lower Court, without any basis or known reason, varied from the Respondent's determination. The Commissioner attributed 41.523 per cent of available earnings and profits of Gene Clark, Inc., for fiscal 1948 to its stockholder's calendar year 1947. The Tax Court applied 100 per cent of the available earnings and profits of the corporation's fiscal year 1948 to its stockholders.

If the lower Court had followed Respondent's theory, only $17,466.62 (41.523% of $42,064.92) would have been attributable to the stockholder's calendar year 1947. Of this amount, 70 per cent was attributed to Petitioners, making a total distribution to them of only $12,226.63.

The proper approach to the problem, with correct computations, has been set forth in Petitioners' Opening Brief [pp. 23-26, incl., and Exs. D and E of the Appendix]. The result reached above, aside from other errors, does

not take into account the deductibility of $77,207.15 of asserted 1948 transactions [Ex. F of Appendix to Pet. Op. Br.] or the $20,000.00 dividend paid to Gene Clark, from earnings and profits available for distribution in 1947.

It must be made clear that contrary to Respondent's assertion (Resp. Br. p. 42), Petitioners have always contested the entire deficiency set up against them for each year involved. Petitioners did stipulate certain transactions were not reported by the corporation or the Petitioners on their returns. This does *not* mean Petitioners admitted that they received the proceeds of such transactions for their own use, or that they should have reported these corporate transactions on their individual returns. Moreover, all of the so-called substituted items listed by the Respondent as being uncontested or stipulated were shown at the trial to have been reported on the returns of Gene Clark, Inc. [R. 460, 461].

In his brief, Respondent (Resp. Br. p. 54) accuses counsel for Petitioners of distorting the lower Court's findings by so-called self-serving computations. Petitioners consider this is a serious matter for it is tantamount to an accusation that counsel for Petitioners are attempting to deceive this Court by misstating the record. Specifically in answer to footnote 11 at page 54 of Respondent's Brief, the Tax Court did not leave out of its computation the deferred income item of $5,080.40 for fiscal year 1948 in reconstructing total fiscal 1948 distributions. The $5,080.40 item is part of the $104,408.02 earnings and profits available for distribution [R. 122].

The Respondent states also that the $5,080.40 was included in total distributions in Taxpayer's Exhibit F Summary, "not once but twice." This statement is likewise

erroneous. Exhibit F of Petitioners' Brief, page 9 of Appendix, sets forth a total of $77,207.15, representing transactions which occurred in the calendar year 1948, as follows:

Substituted deposits		$ 9,503.34
Unreported income in other banks accounts		39,300.87
Gain on sale of assets		2,245.09
Advance on Contract Sales		5,080.40
Other Items of Unreported Income—Schedule 2 of Exhibit 3-C		
January 9, 1948—Allen T. Mitchell & Son	$ 2,294.50	
February 10, 1948—A & F Plumbing & Heating	2,223.76	
March 2, 1948—Valley Boulevard Plumbing & Electric Co.	12,000.00	
April 21, 1948—Ben Lang	1,558.44	
April 30, 1948—Ben Lang (contra item)	1,300.75	
February 12, 1948—Sale of Truck [Ex. Y]	1,700.00	21,077.45
Total		$77,207.15

Exhibit E of Petitioners' Brief, page 5 of Appendix, includes the amount of $63,488.47. This amount represents items which the Revenue Agent determined in his report [Ex. 3-C] were not available for distribution in Gene Clark, Inc.'s fiscal year ending April 30, 1947, but were available for distribution in its fiscal year ending April 30, 1948. The Revenue Agent's Report, as has been stated many times throughout Petitioners' Brief, was the basis of the deficiency notice. This amount has, therefore, been treated exactly the same as the Respondent asserted it should be treated in his deficiency notice, *i.e.*, as an amount not being available for distribution in fiscal 1947, but therefore available in fiscal year 1948 of Gene Clark, Inc. The Tax Court without affirmative evidence, on the other hand, treated it as being available for distribution in fiscal 1947 and therefore eliminated these items in fiscal 1948 [R. 122].

Appellate Review of Findings of Tax Court.

Respondent states that "on factual issues, such as are presently presented, the Tax Court's determination should not properly be disturbed on review unless clearly erroneous" [R. 34].

It is well settled that findings such as those that now confront us, *i.e.*, that all asserted available earnings and profits of a corporation were actually distributed to such corporation's stockholders at particular times, are in the nature of ultimate findings of fact, and since such findings are but legal inferences from other facts, they are subject to review free of the restraint of the so-called "clearly erroneous" doctrine.

> *Curtis Company v. Commissioner* (3d Cir., 1956), 232 F. 2d 167, 168;
>
> *Raymond Pearson Motor Company, et al. v. Commissioner* (5th Cir., 1957), 246 F. 2d 509.

This Court in *Gillette's Estate v. Commissioner* (9th Cir., 1950), 182 F. 2d 1010 at 1014 and 1015, stated:

> "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed. * * *"
>
> "* * * it is in no way derogatory to the Tax Court to say that United States Court of Appeals are as well equipped to draw inferences as is the Tax Court and for that reason the Tax Court decision calls for little more weight than its logic suggests."

B. The Tax Court Erred in Finding and Concluding That the Commissioner Had Sustained His Burden of Proving Fraud.

The matter of fraud has been fully covered in Petitioners' Opening Brief (pp. 28-31, incl.).

The Respondent has merely restated the Tax Court's opinion. The Petitioners, therefore, do not feel that further elaboration in regard to this issue is warranted.

C. Section 275(c) Bars the Assessment and Collection of Any Deficiencies.

The Respondent agrees that he has the burden of proof to establish by affirmative evidence that at least $2,282.63 (25% of the reported calendar year 1947 gross income of each of the Petitioners) was omitted from Petitioners' returns (Resp. Br. p. 65).

He specifies the following 1947 transactions as proving there was such an omission:

Exhibit	Item	Amount
U	Hamilton Homes	$1,221.00
V	Hamilton Homes	2,170.00
W	Hamilton Homes	2,295.00
X	H. K. Niles	1,000.00
AA	Valley Cities Supply Company (endorsed by Koyl)	2,731.54
	TOTAL	$9,417.54

Exhibits U, V, W and X were so-called substituted deposits. They were deposited in Gene Clark, Inc.'s bank account and reported on its return [R. 458, 460, 461, 471]. If other items were substituted for these checks, there was absolutely no proof presented in the trial of

this case. The Commissioner cannot sustain his burden of proof by a mere arbitrary theory.

Exhibit AA is a check which was endorsed by Archie Koyl, indicating that he was the recipient of this check. This check, standing alone, is not evidence that Petitioners received the proceeds thereof.

Conclusion.

The determination of the Commissioner was incorrect. This was recognized by the lower Court during the trial of this case [R. 187]. Although the Petitioners proved the method used by the Commissioner to arrive at the deficiencies was arbitrary and produced erroneous results, the determinations of the Commissioner, based upon such method, were sustained.

The instant case is analogous to *Gasper v. Commissioner* (6th Cir., 1955), 225 F. 2d 284. Under similar circumstances to those now under consideration, the Court stated, at page 287:

> "The Tax Court, therefore, held that while the method adopted by the Commissioner to determine deficiencies of petitioner is wrong and obviously leads to an incorrect conclusion, nevertheless, since the Commissioner had made such a determination—even though by such an erroneous method—the burden was upon the petitioner to show that the method used produced erroneous results. Although petitioner proved that, for the year 1945, the method produced erroneous results, and although the same method was used by the Commissioner for the other taxable year, and according to the Tax Court, was a wrong method and not calculated to produce correct results, the determinations of the Commissioner, based upon such a method, were sustained.

> "The above conclusion of the Tax Court appears directly contrary to the holding of the Supreme Court in Helvering v. Taylor, 293 U. S. 507, 55 S. Ct. 287, 289, 79 L. Ed. 623."

In summary, Respondent's Brief does nothing to strengthen the weaknesses of the Tax Court's opinion, which Petitioners have heretofore discussed in their Opening Brief. The conclusion of the Tax Court still remains erroneous and its decision should therefore, be reversed and judgment entered in favor of the Petitioners.

Dated: November 6, 1958.

Respectfully submitted,

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